CIBC Asset Management

September 2018

MARKET SPOTLIGHT

GLOBAL MARKETS

While much of the world struggles with debt problems (Italy and others), U.S.-imposed trade sanctions (China, Iran, Turkey) and currency troubles (Brazil, Argentina, Turkey are notable), the U.S. economy is charging ahead. As a result, U.S. stocks lifted the global equity index in August, as the MSCI World Index gained 1.2% (USD), and 1.4% (CAD), with the Canadian dollar slightly weaker.

U.S. broad equity markets rose 3.3% while the Nasdaq 100 gained 6%. An increasing amount of data supports the belief that the U.S. economy is performing extremely well. Second quarter U.S. GDP was reported at +4.1% (annualized), the best performance since 2014. Both business and consumer sentiment readings are registering very optimistic outlooks. The jobs market continues to improve to the point that wages are increasing, raising fears of accelerated interest rate hikes.

International developed equity markets declined -1.9% (USD), with Japanese equities up 0.2% (USD). Europe is currently facing a number of political challenges, including an impending deadline for a Brexit deal and growing concern over the state of the Italian economy and its banks. The European Central Bank is a major holder of Italian debt, so an Italian banking crisis would be felt right across the EU.

Emerging markets fell -2.7% (USD), with China lower by -3.8% (USD). Currency issues and trade sanctions are two big factors currently moving these markets. South American emerging markets, in particular, are experiencing large currency declines (vs. USD). One positive development was the completion of a NAFTA deal between the U.S. and Mexico—the bright spot amid an escalating global trade war.

CURRENT ASSET ALLOCATION OUTLOOK*

ASSET CLASS	WEIGHTING
Canadian Bonds	Underweight
International Bonds	Underweight
Canadian Equities	Market Weight
U.S. Equities	Underweight
International Equities	Overweight
Emerging Market Equities	Overweight

* For balanced portfolios, as at August 31, 2018.

SOUND BITES

Luc de la Durantaye

"The valuation gap between emerging markets (EM) and the U.S. started to shrink early in 2018 when EM was outperforming, but this trend reversed in the second quarter. The valuation discount of emerging markets compared to the U.S. is now at its widest since 2002. Valuation arguments still favour emerging markets versus other major global regions.

The relative performance of emerging vs. developed markets (DM) is well explained by two factors, both of which have recently favoured DM. EM usually outperforms when its growth rate compared to developed markets is increasing and when the U.S. dollar is weak. Our economic forecasts indicate a reacceleration of growth in the short term in the U.S., coupled with a slowdown in China—this will continue to act as a headwind for EM. The ongoing USD liquidity squeeze and dollar strength have also created a period of EM underperformance. We do not expect much USD appreciation from here, so the pressure on EM will likely diminish over the next 12 months."

FIXED INCOME

The bond market posted positive returns, despite evidence that Canada's economy has been doing well enough to justify another increase in interest rates from the Bank of Canada in 2018. Yields declined in response to concerns that trade talks with the U.S. were not progressing and worries that some emerging markets were feeling stress from higher interest rates and a stronger U.S. dollar. U.S. yields followed a similar path, despite expectations that the Federal Reserve is poised to increase its rate in September. The stability in bond yields was helped by expectations that while inflation has moved higher, it is expected to remain contained.

CANADIAN EQUITY

The Canadian equity market fell -0.8%. The financial sector was a bright spot (+1%) as Canadian banks released impressive quarterly earnings results and raised dividends in many cases. The tiny (by market capitalization) Canadian healthcare sector jumped 28%, as marijuana stocks surged. The energy (-3.6%) and materials (-8%) sectors were lower, with global trade sanctions complicating the outlook for these companies. Although the loonie is feeling the impact of stalled NAFTA talks and U.S. trade sanctions, Canadian equities have turned in a positive performance over the past three months (+2%). This is a better performance than most international equity markets.

SOUND BITES

Patrick O'Toole

Vice President,
Global Fixed Income

Risks abound whether they be pressures from foreign markets, political turbulence, geopolitical conflicts or volatile commodity prices. But the immediacy of those risks are not all created equal, and investors focus on those that seem closest at hand. Today's front-and-centre risk for Canadian investors is the NAFTA renegotiations. Some may argue that our stock and bond markets are not pricing in much risk; however, the TSX has notably lagged the S&P since the aluminum and steel tariffs were implemented and since Canada was excluded from U.S./Mexico negotiations. There are certainly other factors that are partially to blame for the laggard TSX (inter-provincial trade tiffs come to mind); however, NAFTA matters., If Canada and the U.S. can come to an agreement on a new framework, a cloud will lift over our market. That will leave one less headwind facing the economy, providing the Bank of Canada (BoC) more freedom to focus on how fast it takes its interest rate back up from its current 1.5%, to its neutral target of 2.5—3.5%.

However, that does not mean that the BoC will necessarily accelerate the pace at which it moves to target. Canada's economy is not firing on all cylinders. The impact to the housing market from revised mortgage qualification rules are still to fully play out. The hurdles that the energy industry faces that have kept the differential between what Canadian producers get for oil versus the U.S. price are painful and may linger while producers struggle to move oil to market. Consumers have also been on a debt binge this cycle, leaving them more sensitive to the rate hikes that have taken place over the past couple of years.

While most Canadians will rejoice when/if we reach a successful renegotiation of NAFTA, the celebration may not last. Canada's economy still faces more headwinds than tailwinds and, even assuming that NAFTA is resolved, we expect growth to slow somewhat over the next year. However, short-term pain may give way to long-term gain for all if actions taken by the U.S. result in freer global trade.